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No. 830

In the Supreme Court of the United States

OCTOBER TERM, 1957

CAPITOL COAL CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (Pet. 21-44) is reported at 26 T. C. 1183. The opinion of the Court of Appeals (Pet. 15-19) is reported at 250 F. 2d 361.

JURISDICTION

The judgment of the Court of Appeals was entered on December 6, 1957. (Pet. 20.) The petition for a writ of certiorari was filed on March 4, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254(1).

QUESTION PRESENTED

Whether the Court of Appeals erred in holding that for the tax benefit rule to be applicable the recovery in the subsequent year must be definitely related to the loss in the earlier year from which no tax benefit was derived.

STATUTE AND REGULATIONS INVOLVED

The relevant portions of Section 22(b)(12) of the Internal Revenue Code, and of Section 29.22(b)(12)-1, as amended, of Treasury Regulations 111, are set forth in the Appendix, *infra*, pp. 10-12.

STATEMENT

Taxpayer is a dealer in coal and oil, purchasing from wholesalers and selling to consumers and jobbers. (R. 8-A.) In 1942, it was indebted to the George E. Warren Corporation, to L. F. Kaine & Company, and to Cities Service Oil Company in the total amount of $95,908.63. (R. 13-A.)[1] Of this total, debts aggregating $69,644.36 were cancelled by its creditors during taxpayer's fiscal year ended May 31, 1942. Immediately after the cancellations, taxpayer was solvent to the extent of $28,037.49. (R. 14-A—16-A.) The Commissioner determined that taxpayer received income in that year from the debt cancellations to the extent of $28,037.49. (R. 18-A.) Taxpayer contended in the Tax Court and the Court of Appeals that the amounts cancelled were gifts and not income. Those courts decided this issue adversely to the taxpayer (R. 24-A, Pet. 17-18), and no review

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[1] Also involved in the deficiency notice was a $1,000 debt to the Foreston Coal Co., the cancellation of which the Tax Court held to be a gift.

is sought of this holding.

Alternatively, taxpayer argued that the debts arose from the purchase of coal and oil during the fiscal year ended May 31, 1939, that its allowable deductions for that year exceeded its income by $69,642.33, and that accordingly, under the tax benefit rule, only $2.03 should be included in income for the fiscal year ended May 31, 1942. (R. 9A, 25-A, Pet. 18.)

Taxpayer's statement of operations covering the period June 1, 1938, to May 31, 1939 (R. 8-A—9-A) is as follows:

Net sales			$982,406.23
Material costs:			
Inventory—June 1, 1938	$ 15,641.28		
Coal and oil purchases, freight, towing, boating, insurance, etc.	805,298.07		
	$820,939.35		
Less inventory—May 31, 1939	9,169.44	$811,769.91	
Yard costs:			
Labor	$ 12,539.08		
Rent	5,499.96		
Repairs	1,459.37		
Light and power	782.74		
Depreciation	10,667.72	30,948.87	
Delivery Costs:			
Trucking	$ 73,702.32		
Hoisting labor	920.07		
Insurance	5,957.56		
Sundry shipping costs	5,248.50	85,828.45	
Selling costs:			
Salaries and commissions	$ 30,905.57		
Officers' salaries	12,000.00		
Salesmen's expenses	13,014.66		
Advertising	1,214.78	57,135.01	
Total			985,682.24
Balance—deficiency			$(3,276.01)

General and administrative expense:		
Officers' salaries	$ 12,000.00	
Bad debts	6,125.74	
Interest	14,430.57	
Taxes	4,682.68	
Other deductions, salaries, etc.	39,740.91	75,979.90
Total (loss)		$(79,255.91)
Other income		9,613.58
Net (Loss) for Year		$(69,642.33)

The Tax Court stated (Pet. 40)—

> In the present case, the indebtedness of $69,644.36 canceled subsequently by the three suppliers of coal and oil represents only a small portion of the coal and oil purchased in the fiscal year 1939 and we cannot say that the coal and oil represented by this amount was sold at a loss.

The Court of Appeals agreed, stating (Pet. 19) that—

> At best the taxpayer has shown that purchases were made in 1939 but it has not related the alleged 1942 recovery to the 1939 losses.

The court held that the tax benefit rule was inapplicable here where, under the facts, the recovery can not be definitely related to the loss.

ARGUMENT

It is settled that a debtor receives taxable income from the cancellation of a debt (*Commissioner* v. *Jacobson*, 336 U. S. 28, 38-41), unless, under the circumstances of the particular case, the cancellation

is to be considered as a gift, or as a contribution to capital. The courts below held that the cancellations here involved resulted in taxable income, and taxpayer here accepts that holding. Nor does taxpayer argue that the cancellation should in some way be treated as a reduction of the basis of property held by it. Rather, its contention is that under the tax-benefit rule this income of a later year should be regarded as the recovery of a loss of a prior year.

In refusing to extend the tax benefit rule to a situation where income of one year cannot be identified as the recovery of a loss of a prior year, the courts below were clearly correct. To have done otherwise would have been to disregard completely one of the fundamental principles of the federal income tax system, that of the annual accounting period.

It has been firmly established since this Court's decision in *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, that the basic pattern of the income tax Acts has been to assess the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period. As this Court there said (pp. 364-365):

> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

And see *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, 286.

Although Congress has mitigated the strictness of this pattern in some situations, as in the provisions for limited net operating loss carry-over (Internal Revenue Code of 1939, Section 122) and a limited capital loss carry-over (Code, Section 117(e)), the basic pattern has remained unchanged.

A further exception is the so-called tax benefit rule, codified in part in Section 22(b)(12) of the Internal Revenue Code of 1939, added by Section 116(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798. (Appendix, *infra*, pp. 10-11.) The rule allows a taxpayer to exclude from his gross income any amount recovered on account of certain items which, when deducted in prior years, did not reduce the taxes due for such earlier years. Such items listed in Section 22(b)(12) are bad debts, prior taxes, and delinquency accounts. None of these items is here involved.

Following this Court's decision in *Dobson* v. *Commissioner*, 320 U. S. 489, the Regulations dealing with Section 22(b)(12) were amended to permit further exclusions. In the *Dobson* case a taxpayer, who took a deduction for a loss on the sale of stock and recovered on such stock in a later year, was allowed to exclude the amount of the recovery from taxable income because no tax benefit was secured from the deduction in the prior year. The Regulations, as amended by T. D. 5454, 1945 Cum. Bull. 68 (Appendix, *infra*, pp. 11-12), applied the rule to all other losses, expenditures, and accruals made the

basis of deductions from gross income for prior taxable years.

Even under this expansion, the amount received in the subsequent year must be a recovery of an earlier loss. In holding that in order to treat any gain as a recovery and as excludible from taxable income, it must be shown that the recovery can be definitely related to the loss, the court below is in accord with *Sloane* v. *Commissioner*, 188 F. 2d 254, 262 (C. A. 6th), and *Waynesboro Knitting Co.* v. *Commissioner*, 225 F. 2d 477, 480 (C. A. 3d). It must be shown that the event which produced the gain has such close relationship to the event which produced the loss (or other item deducted without tax benefit in a prior year) that they can be considered as parts of one and the same transaction. On the facts as found by both courts below, there is no such direct relationship here.

Furthermore, Congress has dealt specifically with one phase of the receipt by a corporation of income from the discharge of indebtedness, providing that in the prescribed cases the amount shall be excluded from income, but shall be applied to reduce the basis of certain property held by the taxpayer. A portion at least of the gain will be recognized on subsequent sale or exchange of the property. Section 22(b)(9) of the Internal Revenue Code of 1939; Section 108(a) of the Internal Revenue Code of 1954. By so stating the conditions under which the gain from cancellation of indebtedness is to be excluded from income, Congress has indicated that it is not otherwise to be excluded. See *Commissioner* v. *Jacobson*, 336 U. S., pp. 41-47.

The decision of the Court of Claims in *Quincy Mining Co.* v. *United States*, 156 F. Supp. 913, is not in conflict with the decision below. There the majority opinion found as a fact that (p. 916):

> The money which it received in 1947 was, in part, attributable to the expense which had been incurred in 1920. Some of that expense had never had any tax consequences, since, even without it, there was no income to tax. We think it was, in fact, a part of the cost of the copper sold in 1947 * * *.

There the Court of Claims, perhaps erroneously, allowed the taxpayer to allocate part of the costs of the earlier year to the assets sold in the taxable year, holding the taxpayer not estopped by its earlier allocation of costs. In the present case, however, the assets in connection with which the debts arose had been disposed of long before the taxable year. There is here no question of adjusting the basis of assets sold; there is merely the receipt of income from the simple cancellation of a debt.

Furthermore, the decision of the Court of Claims is in effect a finding of fact that there was a direct, identifiable relationship between the income of 1947 and the expense of 1920. Similarly, in *Tuttle* v. *United States*, 101 F. Supp. 532, 535 (C. Cls), the court found as a fact that the events were "all a part of one transaction," and under the facts of that case the later income could be identified as a recovery of an earlier loss. Here, however, the undisputed fact findings of both courts below are to the contrary.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL, 1958.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

* * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(12) [as added by Sec. 116(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

* * * * *

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion," with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount ex-

cludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.22(b)(12)-1 [as amended by T. D. 5454, 1945 Cum. Bull. 68]. *Recovery of Certain Items Previously Deducted.*—(a) *In general.*—Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. (See *Dobson* v. *Commissioner*, 64 S. Ct. 239.) The term "recovery exclusion" as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22(b)(12)), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) *Section 22(b)(12) items.*—The term "section 22(b)(12) items" as used in these regulations means those bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. * * * A typical example of the other items not expressly referred to in section 22(b)(12) but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

(2) *Definition of "recovery."*—Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 22(b)(12) items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. * * *

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